General Services Administration
Office of General Counsel
Washington, DC 20405

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December 18, 1995

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Subject: Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1.

Dear Mr. Caton:

Enclosed please find the original and nine copies of the General Services Administration's Comments for filing in the above-referenced proceeding.

Sincerely,

Jody B. Burton

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Assistant General Counsel
Personal Property Division

Enclosures

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

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COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

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SUMMARY

As the agency vested with the responsibility for procuring telecommunications services for use of the Federal Executive Agencies, GSA has long supported the Commission's price cap plan for regulation of local exchange carriers. The Commission's price cap plan is intended to prevent the LECs from extracting monopoly rents from services over which they exercise pricing power. At the same time, the price cap plan is intended to provide the LECs with incentives to improve their productivity over time to the benefit of both the carriers and the public. In these Comments, GSA offers recommendations for modifications of the plan to ensure the continued provision by the LECs of high quality services at just and reasonable rates.

GSA recommends that the Commission implement a five year moving average X-Factor in 1996. GSA recommends that the calculation of this X-Factor be according to the Historical Revenue Method as described by the Commission.

GSA further recommends that each LEC be allowed to select an X-Factor from among three options each year. The middle X-Factor would be based upon the LEC's past performance as calculated according to the Historical Revenue Method. Under this option, a LEC would be required to share half of its earnings in excess of 100 basis points above the target rate of return. The second option would allow the LEC to choose an X-Factor one percent higher than its past performance. In return, the LEC would not be required to share its earnings until they exceed the target by over 300 basis points. The third X-Factor option would be one percent lower than past performance. With this option, the LEC would have to share half of all of its earnings in excess of the target rate

of return.

GSA does not recommend that the above X-Factor and sharing rules be modified as competition evolves in LEC markets. Instead, GSA recommends that the Commission eliminate price cap regulation altogether for LEC services which become fully competitive in individual markets.

Finally, GSA recommends that the Commission conduct a performance review of all aspects of its LEC price cap plan in 1997.

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA"), on behalf of the Federal Executive Agencies, submits these Comments in response to the Commission's Fourth Further Notice of Proposed Rulemaking in CC Docket No. 94-1 ("Fourth NPRM"), FCC 95-406, released September 27, 1995. Pursuant to the Commission's Order on Motion for Extension of Time, DA 95-2340, released November 13, 1995, GSA will also comment on certain issues related to the Commission's Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1 ("Second NPRM"), FCC 95-393, released September 20, 1995. In these NPRMs, the Commission requested comments and replies on proposed changes to its price cap plan methodology.

I. INTRODUCTION

As the agency vested with the responsibility for procuring telecommunications services for use of the Federal Executive Agencies, GSA has long supported the Commission's price cap plan for the regulation of local exchange carriers ("LECs"). GSA filed Comments on May 9, 1994, Reply Comments on June 29, 1994, and Supplemental Comments on January 31, 1995, in this proceeding.

The Commission's price cap plan is intended to prevent the LECs from extracting monopoly rents from services over which they exercise pricing power. At the same time, the price cap plan is intended to provide the LECs with incentives to improve their productivity over time to the benefit of both the carriers and the public.

The core mechanism of the price cap plan is a formula which allows the LECs to increase their prices each year by a measure of inflation, the Gross Domestic Product-Price Index ("GDP-PI"), offset by an "X-Factor" intended to reflect expected improvements in LEC efficiency. The plan also includes a "sharing" feature, under which the LECs are required to share their earnings over a certain level with ratepayers through rate reductions.

In these Comments, GSA will respond to the Commission's request for comments on various modifications to the mechanics of the price cap plan. GSA's recommendations are intended to ensure the continued provision by the LECs of high quality services at just and reasonable rates.

II. COMMENTS ON FOURTH NPRM

Issues 1 and 2 - X-Factor Calculation

The Commission invites comments on the development of the X-Factor used in the price cap formula.[1] The Commission proposes three alternative approaches to this development.

Under the "Total Factor Productivity" ("TFP") approach, the X-Factor would be based upon TFP studies designed to determine the increase in productivity of the LECs, as measured by the increase in output per unit of input at constant prices. As the Commission recognizes, however, "changes in a firm's unit cost of output come from two general sources: (1) changes in the way a firm uses resources in the production process, *i.e.*, changes in productivity; and (2) changes in the price of those resources, *i.e.*, input price changes."[2] Accordingly, the TFP factor would have to be combined with an input price change factor to determine the X-Factor as it is used in the price cap formula.

Under the "Historical Revenue Method," the X-Factor is calculated directly by determining what X-Factor would have resulted in constant earnings over the price cap period under examination. The X-Factor developed in this manner encompasses, but does not separately identify, improvements in LEC productivity and changes in LEC input prices.

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[1] Fourth NPRM, para. 13-95.

[2] Id., para. 54.

The third approach to determining the X-Factor is called the "Historical Price Method." This method is conceptually similar to the Historical Revenue Method, since it determines the X-Factor which would have resulted in observed prices given constant earnings over the period under examination.

GSA believes that the Commission, the industry, and the public will be best served by the Historical Revenue Method over the long-run. This method is simple to apply and avoids the complex and contentious theoretical calculations integral to the TFP method. It is also marginally more direct and easy to understand than the Historical Price Method. The fact that this method does not differentiate between unit cost improvements due to LEC productivity and input price changes is of no importance given the use of the X-Factor in the price cap formula. If individual LECs believe TFP studies will be useful in managing their business, they are free to perform them. But such theoretically interesting data is of no practical significance in the determination of the X-Factor.

Issue 3 - Updating of X-Factor

The Commission invites comments on whether the X-Factor should be fixed for some period of time or based upon some type of moving average.[3] If a moving average is used, the Commission seeks comments on the period of time for its calculation.[4]

The United States Telecommunications Association ("USTA") first recommended that a moving average be used to determine the X-Factor in an Ex Parte submission

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[3] Id., para. 96-107.

[4] Id., para. 100-101.

made before the Commission on January 18, 1995. In Comments filed on January 31, 1995, GSA supported the concept of a moving average as long as it is based on the Historical Revenue Method of calculating the X-Factor. GSA continues to favor this approach.

To be fair to both carriers and ratepayers, the moving average period should be relatively current, but long enough to even out temporary aberrations to overall trends. GSA believes that USTA's recommendation of a five year period would meet this criterion, but GSA believes that the average should start no earlier than 1991, the first year of LEC price caps. The first application of this procedure would thus require actual data for the years 1991-1995. Since this data will be available early next year, GSA recommends that the implementation of the five year moving average according to the Historical Revenue Method be in conjunction with the LEC 1996 access charge filings.

Issue 4 - Number of X-Factors

The Commission invites Comments on whether there should be a single X-Factor or multiple X-Factors.[5] The Commission also seeks comments on whether the LECs should have a choice in the selection of X-Factors under a multiple X-Factor plan.[6]

As the Commission recognizes, there is a strong argument for establishing multiple X-Factors so that the plan can be made to fit the particular circumstances of each price

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[5] Fourth NPRM, para. 108-109.

[6] Id., para. 110-111.

cap LEC.[7] The Commission states:

> A single X-Factor, however, would not adequately reflect differences in the economic conditions faced by each LEC and thus could unfairly penalize or reward LECs which face conditions that differ from the industry average. For example, there are variations among the LECs' service regions with respect to level of growth in the overall economy, the proportion of rural and urban areas for which service is provided, and level of competition in the provision of telecommunications services.[8]

GSA agrees with the Commission's analysis and recommends that each LEC be allowed to select one of three X-Factors each year based upon its expectations of performance in the following year. The middle X-Factor would be based upon the LEC's five year moving average of past performance according to the Historical Revenue Method, as described above. If the carrier expects to do relatively well in the next year, it could select an X-Factor which is one percent higher. In return for the larger rate reduction which would result from this selection, the LEC's no sharing zone would be extended by two percent. A one percent change in X-Factor, taken by itself, results in about a 0.5 percent change in rate of return.[9] After 50/50 sharing, a LEC selecting the higher level of X-Factor would "break-even" if its efficiency improved by two percent compared to the five year moving average, and profit if its efficiency improved by more than two percent.

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[7] Id., para. 109.

[8] Id., para. 109.

[9] Comments of AT&T, May 9, 1994, Appendix C, Table C.1.

Conversely, if a LEC expected its performance to be less than average, it would be allowed to select an X-Factor which was one percent lower than the five year moving average. The no-sharing zone would be eliminated for such a LEC.

Issue 5 - Sharing Requirements

The Commission invites comments on whether the sharing and low-end adjustment aspects of its price cap plan should be modified or eliminated.[10] In particular, the Commission seeks comments on the role that sharing should take in the selection of an X-Factor.[11]

The 50/50 sharing feature of the Commission's price cap plan strikes an appropriate balance between the interests of ratepayers and carriers. On the one hand, it provides a "safety-net" to prevent the LECs from achieving supra-competitive profits at the expense of ratepayers. On the other hand, it provides the carriers with an incentive to improve their efficiency.

The current price cap plan includes features under certain options which unreasonably tips this balance of conflicting interests. The current plan completely eliminates sharing for LECs which choose a 5.3 percent X-Factor. This feature removes the "safety net" protecting ratepayers and should be eliminated. Since the earnings level of a LEC can vary greatly from year to year for many reasons beyond the LEC's control, the complete elimination of sharing under any option could lead to unjust LEC windfalls

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[10] Fourth NPRM, para. 112-129.

[11] Id., para. 117-119.

of significant proportion.

On the opposite extreme, the other two current price cap options contain provisions which require a 100 percent sharing of LEC earnings over specified levels. This feature should also be eliminated, since it removes any incentive for the LECs to improve their efficiency beyond a certain level.

GSA recommends that the sharing mechanism be modified in accordance with its above recommendations for X-Factor selection. Under the base plan, the currently authorized rate of return would serve as a target return. Earnings within 100 basis points of this target would be in a no-sharing zone. Earnings above this 100 basis point limit would be subject to 50/50 sharing. Carriers whose earnings fall more than 100 basis points below this target would be entitled to a low-end adjustment to return them to the bottom of the no-sharing zone.

If a carrier selected the one percent higher X-Factor, the carrier would be allowed to retain all earnings up to 300 basis points above the target. 50/50 sharing would commence above this level. If a carrier selected the one percent lower X-Factor, all earnings above the target would be subject to 50/50 sharing.

GSA believes that these sharing rules would provide both an incentive for LECs to choose the higher X-Factor when their circumstances allow it and a reasonable balancing of ratepayer and carrier interests.

Issue 8 - Performance Review Schedule

The Commission invites comments on whether it would be desirable to schedule another LEC price cap review, and, if so, when this review should be scheduled.[12] The Commission also seeks comments on what aspects of the plan should be included in such a review.[13]

The Commission scheduled its first price cap review in 1994 to examine performance during the first three years of its price cap plan. GSA recommends that the Commission schedule its second review in 1997 to examine performance during the second three years of the plan. GSA further recommends that this second review examine all aspects of the plan, including the target return which serves as the focal point of the sharing mechanism.

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[12] Id., para. 142.

[13] Id., para. 143.

III. COMMENTS ON SECOND NPRM

Issues 19 and 20 - X-Factor and Sharing Flexibility

The Commission invites comments on whether its X-Factor and sharing price cap rules should be modified according to the competitive circumstances faced by a carrier.[14] In particular, the Commission seeks comments on whether competition could be used to replace the "flow-through" function of sharing, as proposed by NYNEX.[15]

No party has been a more consistent supporter of the Commission's efforts to introduce competition into all aspects of telecommunications than GSA. GSA believes that effective competition brings benefits to ratepayers far in excess of those provided by even the most enlightened of regulatory frameworks.

On the other hand, GSA believes that until competition is pervasive and open, the Commission has a fundamental obligation to protect ratepayers from abuse by carriers possessing pricing power for particular services in particular markets. In this connection, GSA applauds the measured steps which the Commission took during the transition of the domestic interexchange market from near monopoly to effectively competitive over the 1984 to 1995 period. The key to the Commission's success in managing this transition was its willingness to remove services from price cap regulation when they became effectively competitive, and not before. Thus, the Commission removed virtually

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[14] Second NPRM, para. 159-172.

[15] Id., para. 163-172.

all of AT&T's private line services from price cap control in 1991;[16] virtually all of AT&T's 800 services in 1993;[17] and all remaining AT&T domestic services in 1995.[18]

The Commission should follow this same road with the LECs. It should continue to vigorously regulate the LECs under its balanced price cap rules for X-Factor determination and sharing as long as they possess market power over services. Rather than tinker with its rules, when a LEC is faced with competition which effectively limits its pricing power over given services in given markets, the Commission should boldly remove these services in these markets from price cap regulation.

The Commission should not apply half-hearted regulation to LECs possessing pricing power under any circumstances. If the marketplace is not restraining LEC pricing, the Commission must. The price cap X-Factor and sharing rules should not be gradually modified as competitive circumstances evolve. Rather, the Commission should remove price cap constraints as soon as effective competition makes them moot.

For these reasons, GSA opposes any plan to tie the level of price caps to the indicators of competition or, as in the NYNEX proposal, to the actions that LECs should take in any case to accomodate competition.

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[16] Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, FCC 91-251, released September 16, 1991.

[17] Id., Second Report and Order, FCC 93-258, released May 14, 1993.

[18] Revisions to Price Cap Rules for AT&T Corp., CC Docket No. 93-197, FCC 95-18, released January 12, 1995. Also, Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, FCC 95-427, released October 23, 1995.

IV. CONCLUSION

As the agency vested with the responsibility for acquiring telecommunications services on a competitive basis for use of the Federal Executive Agencies, GSA urges the Commission to implement a five year moving average X-Factor in 1996 based upon the Historical Revenue Method; allow the LECs to choose between three X-Factors as described herein; modify the sharing mechanism as described herein; and schedule its next price cap performance review in 1997.

Respectfully submitted,

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December 18, 1995

CERTIFICATE OF SERVICE

I Jody B. Burton, do hereby certify that copies of the foregoing "Comments of the General Services Administration" were served this 18th day of December, 1995, by hand delivery or postage paid to the following parties:

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